

StrategicPoint of View[®]

INVESTING 101: THE BASICS

You work hard for your money. You give Uncle Sam his share, you pay your bills, and hopefully you have something left over. But what do you do with it? The media has a multitude of suggestions for where to put your money. Or better yet, that guy at work sounds like he might know something...stop there!

The purpose of this report is to explain investing and how to invest. What you won't find here is the latest hot stock or the "can't lose" deal. Our goal is to provide you with the education needed to determine if investing is for you and if so, how to enter the investment world.

Investing is directing your money toward something in hopes of increasing the value of your investment. It can be swamp land in Florida, a savings bond from your local bank, or ten shares of stock for your grandchild. Any time you set money aside for future financial goals, you are investing.

Getting Started

First, define your goals. The most important aspect of investing—or managing your financial life in

general—is to set specific goals. Investing is the means to attaining these goals. If you are not sure if you should be investing, ask yourself why you want to invest. Is it so you can retire someday? Send your children to school? Ask yourself how much money you could afford to lose—physically and emotionally. In the 90s, investing in technology stocks seemed like a sure bet. Then it all came crashing down. More recently, we have experienced five years of stock market growth, followed by a mortgage and credit crisis that have made the markets volatile. Having goals—and plans to meet these goals—helps you to weather market gyrations.

Second, understand your risk tolerance. *Risk* is the chance of loss. Risk and return are related; as risk increases, so does the chance for a potentially greater return. Unfortunately, as risk increases, so does the chance for a greater loss. Each investor has a different risk tolerance level. *It is crucial to understand your risk tolerance.*

There are many different kinds of risk that can impact the way you invest or manage your money. Systematic risk affects the entire market. For example, changes in interest rates and the wavering value of the dollar can affect stock prices throughout the market. Unsystematic risk is unique to a single stock, company, industry or country. For instance,

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if a company declares bankruptcy, only the shareholders of that company and perhaps others in the same industry would be affected.

Examples of Systematic Risk

Market Risk: the tendency of assets to move up or down with the market

Interest Rate Risk: increase/decrease in the price of securities as a result of interest rate changes

Purchasing Power Risk: chance that assets will lose buying power; as the price of goods increase through inflation, the investor is able to buy fewer things for the same amount of money.

Foreign Currency Risk: changes in the value of the dollar in relationship to other currencies will impact the value of investments

Reinvestment Rate Risk: chance that proceeds from an asset that has matured, been called or sold will need to be reinvested at a lower interest rate

Examples of Unsystematic Risk

Business/Industry Risk: chance that a specific business or industry will suffer loss of income

Financial Risk: chance that a company's debt profile will affect its ability to meet general obligations and generate profits

Default Risk: (applies to bonds only) chance that a company/municipality won't be able to pay interest/principal on its debt obligations

Regulation Risk: changes to laws and tax structure that impact investments

Country Risk: chance political or economic instability will impact the value of a country's securities

Risk can never be completely avoided. Even hiding your money under your mattress subjects you to

purchasing power risk. It is reality that the market goes up and down on a regular basis; this is systematic risk. If you are invested in the stock market and the market declines, your stocks will be negatively impacted to some degree. If you are invested in bonds and interest rates rise or fall, the value of your bonds will change accordingly. On the other hand, unsystematic risk can be reduced and/or avoided. The best way to reduce risk is through broad *diversification* so that the chance of any one security lowering the value of the entire portfolio is small. Successful investors diversify in a way that is consistent with their financial goals and is within their risk tolerance. It is important to diversify across sectors and asset classes.

Assets

An asset is anything you own that has value. This includes your checking account, your retirement plan, your home, and the cash in your cookie jar. Real estate, antiques, bonds and commodities are assets too. Here is a closer look at specific asset types:

Cash: Cash is the most liquid asset type because it is immediately available. However, cash pays only low interest if it is in a savings or checking account and no interest if it is stuffed in your mattress. An alternative to keeping your money in a cash account is a cash equivalent asset, like a money market fund. A money market fund is a mutual fund that invests in commercial paper, banker's acceptances, repurchase agreements, government securities, certificates of deposit, and other highly liquid, safe securities while paying money market rates of interest. A money market account differs from a money market fund in that it is insured by various agencies of the federal government. Money market funds are not insured by any government agency, though they are generally considered safe due to the high quality of their assets.

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Stock (Equity, Share, Issue): If you own stock in a company, you are essentially an owner of that company. If the company does well, your stock could increase in value. If the company declares bankruptcy, you could lose your entire investment. Stocks are subject to many different kinds of risk.

Bond (Fixed Income): If you buy a bond from a bank, a company or the government, you are basically loaning them money. They will pay you interest until it is time to cash in your bond and get your initial payment back in full. Bonds are considered to be relatively safer than stocks because they offer fixed interest payments and while their prices might fluctuate, the investor expects a return of his original investment on a specific date.

Tangibles: A tangible asset is anything that has a physical existence, is worth money and can possibly appreciate in value over time. Precious metals, collectibles and antiques are examples of tangible assets. A commodity is also a tangible asset because it represents ownership of a definite physical item such as sugar, wheat, lumber or pork bellies (the purchaser is not buying ownership rights but the actual item itself). Most investors, however, are not purchasing the tangible commodities when they buy an exchange traded fund or mutual fund that invests in precious metals, oil, etc. Instead they are buying an index that tracks the price of the commodities or a fund that owns companies that produce the commodity.

Miscellaneous Assets: Here's where real estate comes in. This includes your house, any rental properties you own, and land. Home ownership provides tax benefits, such as deductible mortgage interest and deductible real estate taxes, and the benefit of potential appreciation. Developed land (buildings or apartments that provide you with income) can also provide taxable income and depreciation deduction. Because undeveloped land does not provide cash flow, returns come primarily from appreciation.

Investment Strategies

Asset Allocation: determining the right mix of cash, bonds, stocks and other assets for your portfolio. When determining your asset allocation, consider your time horizon, risk level and ultimate goals.

EXAMPLE A:

Jack is 63 years old and wants to retire in a few years years. He doesn't want to risk losing his entire nest egg in the stock market. Jack may want to design a *conservative portfolio*:

- 55% Fixed Income
- 25% Equities
- 18% Cash
- 2% Commodities

EXAMPLE B:

Mary is 27 years old and doesn't expect to need her money for at least 30 years. She is willing to assume higher-than-average risks with the hope of obtaining higher-than-average gain. Mary might choose an *aggressive growth-oriented strategy*:

- 80% Equities
- 10% Fixed Income
- 4% Commodities
- 6% Cash

Even though Mary's time horizon is long, aggressive growth investors are not advised to put 100% of assets into stocks. Likewise, it is reasonable that conservative investors might own a small percentage of stocks.

In between Jack and Mary, investors may choose Balanced or Growth portfolios, which offer asset allocations less risky than the aggressive model but more risky than the conservative one.

Fixed Income Investors: If your objective is a steady, secure stream of income, stick to short term bonds (less than three years). They are less volatile than

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longer-term issues because they span a shorter length of time. Another strategy is to build a ladder portfolio. Each rung of your ladder should consist of a different maturity bond, from one year up to ten years. When the one-year bond matures, you reinvest the money in a new ten-year issue. In this way, you always have more money to reinvest every year and you are somewhat protected from interest rate shifts because you have locked in a range of yields.

Fixed income investors can also utilize bond funds, which hold a particular type of bond (for example, corporate issues) or a widely diversified group of individual bonds. Unlike individual bond securities, bond funds usually do not have a maturity date. They rise in value when interest rates fall and decrease in value when interest rates rise. Over time, the underlying bond holdings are replaced with new issues. If interest rates have risen, the new bonds will offer higher coupon rates, thereby helping to offset the fall in price of the fund itself.

Stock Investors: Perhaps the most important rule for stock investors is *diversification*. In other words, don't put all your eggs in one basket (à la Enron)! If you don't diversify, you risk the chance that one asset will greatly reduce the value of your portfolio and put your financial goals in jeopardy. To protect your portfolio, limit your exposure to any one holding to no more than 5% of your portfolio.

When investing in individual stocks, be sure that they are financially stable companies with above-average earnings growth. Determine if each stock is over or undervalued by looking at its price/earnings ratio (P/E). The P/E is the price per share divided by the company's earnings per share. Ideally, the P/E should be lower than the stock's peer group.

Mutual Fund and ETF Investors: Investors can diversify through mutual funds. Mutual funds are pools of different stocks that are managed by

professional investors. When you buy a mutual fund, you become part owner of a large investment portfolio, along with all the other shareholders of the fund. Each day, the fund manager calculates the value of all the fund's holdings, figures out how many shares have been purchased by shareholders and then calculates the Net Asset Value (NAV) of the mutual fund or the price of a single share of the fund on that day. Mutual funds offer professional management and research as well as a variety of investment models for different situations, including income, capital preservation and growth of assets. Most mutual funds can be opened for as little as \$1,000.

Investors can also choose exchange traded funds. An exchange traded fund (ETF) is an investment company that provides the benefits of mutual funds, like broad diversification, without the big fees or potential trading conflicts. Investors can buy and sell ETFs intra-day, versus the mutual fund world where purchases and sales are based on the closing price on the day of the transaction. Recently, ETFs have developed mass market appeal, as they provide investors with an efficient, cost effective way of acquiring securities. However, the field of ETF options is becoming overcrowded. Be wary of new ETFs which are very narrow in scope, have reduced liquidity or charge higher fees. In addition, ETFs work poorly with dollar cost averaging strategies, since they are subject to ticket charges.

Options: contracts that give the holder the right, but not the obligation, to buy or sell an underlying security, commodity or currency before a certain date. *Put options* give the holder the right to sell at a specified price, while *call options* give the holder the right to buy at a specified price.

Futures: contracts for the sale/purchase of a specified quantity of assets at an agreed-upon price on a given future date. Unlike an option, a futures contract

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obligates both parties to consummate the transaction. Futures are almost always exchange traded.

The “*Buy and Hold*” strategy is when an investor selects a certain group of assets with the intention of holding those assets until he needs the money or his investment needs change. This strategy allows you to ignore the daily fluctuations of the stock market. In addition, during a growth period, your asset allocation will likely overcome temporary losses. There can be some serious disadvantages to the “buy and hold” strategy. A portfolio that is allocated incorrectly and left alone for a period of time could lead to low returns or losses. Also, your risk tolerance will change over time and your portfolio will need to be reallocated accordingly. In addition, the “buy and hold” strategy does not recognize major life events that might alter your needs.

Market Timing: an investment strategy based on attempting to predict future market directions by examining price, volume and/or economic data, and investing based on those predictions. A market timer will frequently move completely out of equities and back into a cash position if he believes that the overall market is going to decrease. When he feels that the market has turned around, he will put all of the assets back into the market. It is common knowledge that *market timing simply does not work*. It is like gambling in a casino. No one can accurately predict what the market will do. Even if a timer does predict correctly, it is unlikely that he will be able to make the necessary changes at the right time in order to make money.

Tactical Asset Allocation: is grounded in the analysis of macro, global economic data and industry/sector trends. Tactical asset allocation does not mean “market timing,” but it is fundamentally different than a “buy and hold” strategy or a passive model based on fixed formulas. Tactical asset allocation requires that the investor establish ranges for the

weighting of each asset class in a portfolio, as well as the specific percentage allocations within the established ranges. This is based on daily economic and market analysis, although portfolio changes are made much less frequently.

While it is virtually impossible for anyone to know exactly when to move an entire portfolio in and out of the markets, it is possible to enhance your risk-reward ratio by making prudent and informed tactical asset allocation decisions. An overall portfolio that is more balanced and tactically managed is one that can help you achieve your financial goals consistent with your risk tolerance.

Common Mistakes to Avoid When Investing

Failure to Develop a Plan: Haphazardly buying and selling the latest hot stock will get you nowhere. Define your goals, develop a plan and stick with it. Readjust your strategy and allocations as your situation changes.

Being Too Greedy: If you are fortunate enough to have an investment increase in value, don’t get greedy. Before you make any investment, set a price at which you will sell the position. For example, if XYZ stock falls below \$30, sell it. Set a price that fits your risk tolerance. You might want to set a price on the upside as well to capture your gains and to avoid the risk of the stock dropping.

In low interest rate environments, investors can make the mistake of going after yield. If the promised or anticipated return on a product or investment seems too good to be true, given current market conditions, it probably is. The higher the yield, the greater the risk.

Failure to Take Enough Risk: Some people err by being too conservative. If you have determined that you have a sufficient time horizon with your portfolio, don’t be afraid to establish some exposure to equities. Time is on your side.

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Penny-Wise, Pound-Foolish: You may have a handle on how much you spend on gas, groceries, and coffee, but have you looked at your 401(k) statement lately? Don't overlook your larger assets at the expense of some of the smaller financial matters that come up in your day-to-day life.

Tax-Tail Wagging the Investment Dog: How often have you said to yourself, "I bought that stock at \$12 and if I sold it, I would owe a ton of taxes." Then you sit back, do nothing, and watch that stock drop from \$80 to \$50 to \$25 to \$10... That big tax liability you were so worried about doesn't look so bad now, does it? Don't let the tax consequences of a position dictate whether or not to sell. Decide to hold or sell a position based on the fundamentals and other factors regarding that particular investment. Owing Uncle Sam is a good problem—that means you've made money!

Failing to Measure Performance: Most of us open our statements without bothering to look at what our accounts are worth or how they have performed. This can be a grave mistake. It is important to monitor your investments and make changes when appropriate. In measuring performance you should use an appropriate benchmark or barometer. If you are a general stock investor, use the S&P 500 because it is the broadest measure of the market. Your goal is to come close to the market's performance with as little risk as possible. Remember that if you are investing for the long run, you will face a declining market at some point in the process.

Making Emotional Decisions: Investors sometimes cling to assets longer than they should due to emotional attachments. A stock might have been a gift from a favorite uncle. A loyal employee might hang on to company stock. Or, the stock may have been a fallen darling and the investor can't bear to accept the loss. Always be objective about your holdings. Review the fundamentals. If the data shows that the

company/ fund is no longer a wise investment, sell it.

Investing Too Soon: This is a common mistake among people who do not have the resources or the cash-flow available to invest. We recommend that folks with a high debt to income ratio (over 36%) hold off on actively investing. This will eliminate the need to sell an investment in the future to pay for lifestyle expenses.

Not Getting Advice: There are enough resources available for investors to manage their own money but the process can be mind-boggling. Attempting to manage your money without advice can be a disaster if you do not do your homework. There is plenty of help out there to guide you through your decisions; you just have to know where to look. You probably wouldn't try to rebuild your car's engine or handle a lawsuit on your own so why would you make important decisions about your portfolio without seeking professional advice?

Getting the Wrong Advice: Make sure the advice-giver is qualified to give it. Ask for credentials, referrals, and talk with current clients if possible. Also, make sure you understand the advice you're getting; ask questions so you can fully understand the recommendations. This is your money and your life—educate yourself and find an advisor who is knowledgeable and trustworthy.

Not Doing your Homework/Investing as a Hobby: One of the key elements to developing and monitoring a successful investment strategy is to conduct a thorough analysis of where your hard earned dollars will give you the best risk adjusted return. After all, it has taken time to accumulate this money; it's certainly worth the time to investigate the best method of investing it.

Most successful professional money managers devote all of their time and resources to managing their

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portfolios. This is a task that is not to be taken lightly. Many people include listening to tips, unfounded rumors and making quick decisions as part of their decision making process. Fidelity's Peter Lynch once said, "Know what you own and why you own it." If you do not do your homework, you have the same chance of success buying stocks as you do at the casino.

Types of Financial Firms

A **Brokerage Firm** is basically the "middle man" between a buyer and a seller of securities, commodities or other investments. A broker might also offer life insurance, asset management and investment banking services. Most brokers work on commission.

A **Mutual Fund Company** offers retirement and non-retirement accounts to individual investors investing directly with the mutual fund company. Investments are usually exclusive to the mutual fund company. Mutual fund companies charge a percentage of the money invested in the fund and may also charge a commission if purchased through a third party.

Banks offer a variety of financial planning products and resources. You can purchase insurance, annuities, mutual funds, treasury services and brokerage services at your local bank. In most cases, banks work on commission.

Asset Management Firms provide financial advice and proactive portfolio management for a fee based on assets under management.

Financial Planners provide comprehensive financial advice for either an hourly fee or by selling a product and charging commissions. Financial planning can also be part of assets-under-management services. When hiring a financial planner, seek out someone who is a Certified Financial Planner[™] certificant.

If you seek to hire a professional in the investment industry, be sure to do your research. Look for someone

who will take the time to understand your situation, needs and objectives and can explain your options clearly. Ideally, look for a Registered Investment Advisor (RIA) who works on a fee-for-service model, rather than on commission. Be aware; arm yourself with the questions that can help you decipher an ethical, qualified advisor from someone who may not be interested in your well being. Ask to see the Form ADV. This is the legal document that ensures you are working with a Registered Investment Advisor.

Questions about this article:

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